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the Illinois CPA

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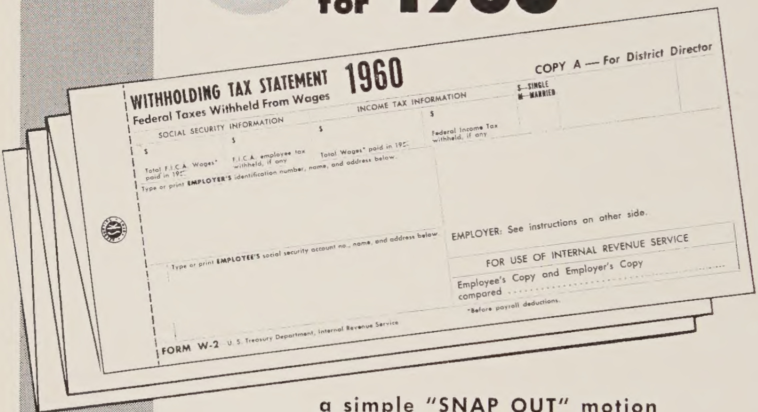
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Total Wages* paid in 19__
Federal Income Tax withheld, if any
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LETTERS TO THE EDITOR

TO THE EDITOR:

In the Winter issue of the *Illinois Certified Public Accountant,* Professor Littleton, in connection with the problem of inflation, seeks to distinguish between analysis and interpretation and suggests that the accountant's function may be limited to analysis. The same suggestion was made in less precise terms in the statement supplementary to Accounting Research Bulletin No. 33, which was issued by the Institute's Committee on Accounting Procedure in October 1948. Analysis must be directed to some objective and the objective determines the form of the analysis. Professor Littleton suggests that the usual financial statements should be "held sharply to analytical marshalling of prior enterprise experience."

But the cases in which income determinations are called for fall into two classes. In one class, large in number but relatively unimportant from the standpoint of public investment and national income, it may be possible to limit accounting analysis to marshalling of prior experience. In the other class, relatively small in number but crucially important from the standpoint of investment and national income, expectations are and must be largely determinative of income for short periods of time. In the later area income determination is necessarily based on assumptions which are known to be invalid, and the best we can hope to accomplish is to develop, in Whitehead's phrase, "new patterns of connexion" which will bring the necessary assumptions nearer to reality.

Unfortunately, the existence of hundreds of thousands of businesses which are relatively small and simple in their structure has seriously retarded progress in dealing with the large and complex corporate enterprises which conduct perhaps three-fourths of the primary production and distribution of goods and services. For these corporations the last step in a determination of income is the deduction of 52 per cent of a sum reached by marshalling of experience and expectations which may be materially different from the marshalling employed in the corporation's own accounting.

The allocations of income to short periods of time are justifiable only because they are indispensable. Admittedly, they are not logical, but Mr. Justice Holmes has said that "the life of the law is not logic but experience;" and the same is true of accounting and of such concepts as national income.

The American Institute of Certified Public Accountants, or groups created by it, has repeatedly emphasized these truths. The first bulletin of its Committee on Accounting Procedure, issued in 1938 said:

> The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet such changes as they occur.

And the Study Group on Concepts of Business Income, which was created by it in 1947, began its Section 3 "Business Income and Accounting" with the statement:

> Business, like income, is a word that conveys a general idea rather than a precise meaning.

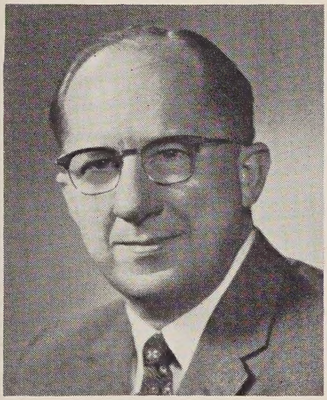
And the second paragraph, quoting Professor J. R. Hicks, said:

> It may be assumed that the task of implementing any concept of business income is essentially an accounting task, but it must always be borne in mind that income and categories related to it 'are not logical categories at all; they are rough approximations, used by the businessman to steer himself through the bewildering changes of situation which confront him.'
>
> J. R. Hicks "Value and Capital" 2nd Ed.
> (The Clarendon Press 1946) P. 171

The Institute's newly created Board of Accounting Principles will doubtless be guided by the same conviction.

George O. May
Southport, Connecticut

RAYMOND A. HOFFMAN



At the Awards Dinner on April 21, 1960, Dr. Lloyd Morey representing the University of Illinois presented 208 CPA certificates based upon the results of the examination last November. The guest speaker was Willis D. Nance, President of the Chicago Bar Association, and the title of his talk was, "What is Your Name?" (See p. 15) The talk pointed out the necessity for each CPA to build up his character and individuality in order to achieve a worthwhile and satisfactory life.

The thought-provoking advice given to the new Illinois CPAs raises a question as to the meaning of the words "certified public accountant"—the name which has been conferred upon us as a professional class. There appears to be a tendency in some cases to attempt to develop a connotation for these words, or the initials "CPA," which is not necessarily justified.

The significance of the title "certified public accountant" is determined basically by the provisions of the statutes of the several states. In Illinois the designation "CPA" represents the attainment of an academic degree evidenced by a certificate issued by the University of Illinois. Under the Illinois Accountancy Act a holder of a CPA certificate issued

President's PAGE

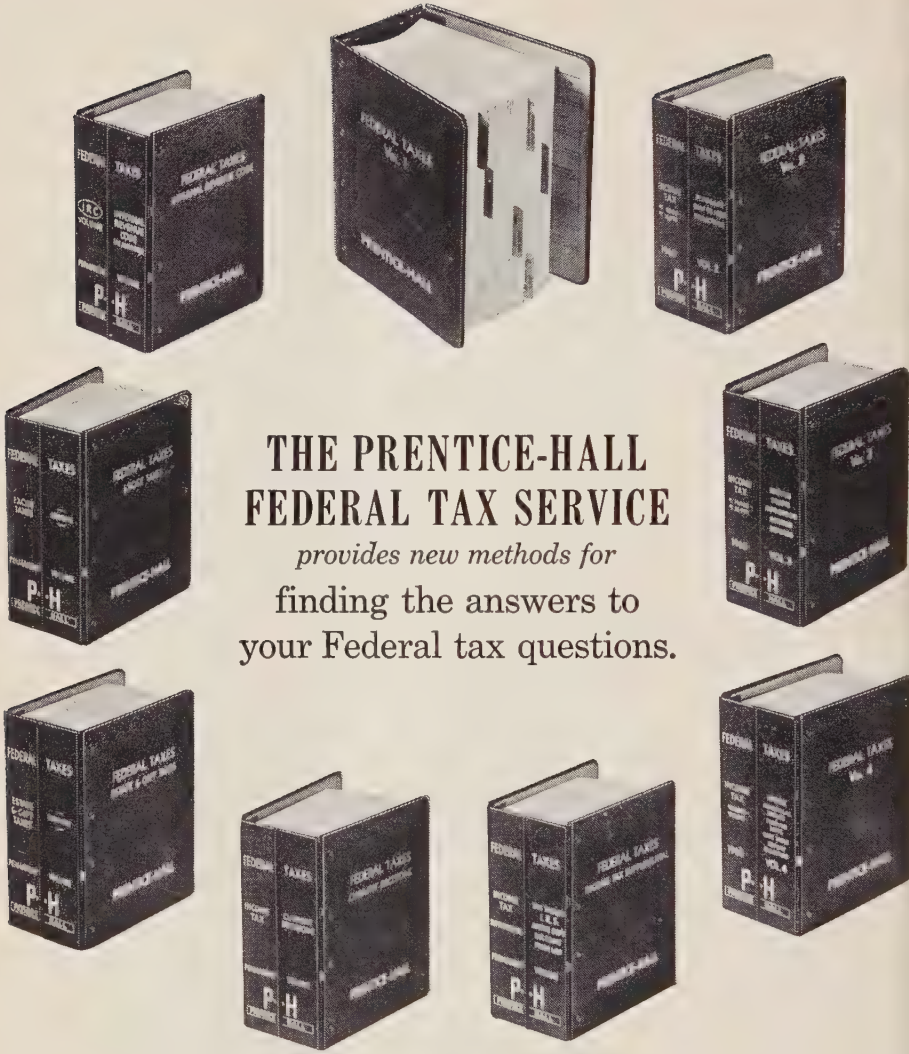
by the University is not entitled to practice accounting in this State until he has been registered as a public accountant by the Department of Registration and Education. It is further provided in the Act that a person who engages in any of the activities described in five meaningful subparagraphs shall be "deemed to be" in practice as a public accountant. There are also sections in the Act enumerating several types of services which are not to be construed as being within the reserved area of practice as a public accountant. The entire Act is worthy of study and of review from time to time.

The practice of public accounting represents a valuable service in the public interest, but in many ways the question, "What is Your Name?", is being asked with regard to the profession as a whole. The opinion has been expressed that CPAs have suffered from the layman's impression we are concerned only with the impersonal affairs of business. In seeking to remedy this situation we should avoid fostering a reputation which goes beyond fact.

It is a reasonably safe guess that every CPA has been invited to keep score at a bridge table or on a golf course merely because of his professional designation. This is one evidence of the inaccurate conception of the general public as to what we do in the practice of accounting. If we were merely human posting machines and adding machines there would be no justification for any type of accountancy act—permissive or regulatory.

The knowledge of CPAs in the area of problems entering into the determination of income has been recognized, by both the Treasury Department and the public, as uniquely qualifying them in the field of federal income tax determination. Similarly, the educational requirements for CPAs include some part of those qualifications necessary to recommend procedures for compiling data and to deal with the problems of business management generally. This does not mean, however, that these functions should

(Continued to page 43)



Are there new avenues open to today's accountant that will allow the more certain exercise of his professional judgment?

Exercising Accounting Judgment

By Charles H. Griffin and Thomas H. Williams

The profile of the professional accountant is a confused admixture of a number of attributes. To many who use his service he is an artful record-keeper, skilled in accurate measurement and precise classification. To others he is a mathematician of unusual dimension, preoccupied with mathematical applications in the solution of business problems. Still others who accept his counsel are reassured by his knowledge of taxation, particularly its computational aspects. Other groups regard him as a financial adviser whose competence derives principally from knowledge of the involvements of the accounting records. The accountant's public image, of which these are but a few features, is in contrast—sometimes striking contrast—to that representation which the accounting fraternity imagines. While accepting his role in the collection, assimilation, and reporting of financial information, the accountant would *additionally* emphasize his exercise of professional judgment and would decry the impression that he is circumscribed by rules and conventions. Yet, dispelling belief in false, or at best only partially correct, impressions may in many instances produce new problems with unfortunate consequences. For example, to give appropriate emphasis to disabusing the public of its reliance upon the accountant's supposed preoccupation with refined calculation may impair confidences which, at present, are a source of his professional strength—confidences unhappily based upon a sense of safety in small numbers. Yet, the accountant insists that the discharge of his responsibilities requires the exercise of reasoned judgment, laboriously acquired through long years of formal education and practical experience.

CHARLES H. GRIFFIN, a professor of accountancy of the University of Illinois, is a member of both the Illinois and Texas Societies of Certified Public Accountants. Professor Griffin is a member of the Committee on the Cooperation with the Interstate Commerce Commission of the Institute of CPA's. THOMAS H. WILLIAMS, an instructor of accountancy of the University of Illinois, is a member of the Ohio Society of Certified Public Accountants.

Operational Activities

Wherein does the accountant give expression to the exercise of professional judgment? For purpose of identifying a few of these areas, it seems convenient to divide the accountant's professional practice (excluding the audit or review function) into four sectors: (1) anticipation and projection, (2) recording, (3) reporting, and (4) analysis and interpretation.

Anticipation and projection. One of the basic responsibilities of business management is that of planning. If operations are to derive the benefits of direction and control, it is necessary that objectives or goals be clearly defined and that plans be formulated for their orderly attainment. The accountant's profitable participation in such business projections is to be observed in his frequent indulgence in before-the-fact forecasting and programming. His hesitancy to inject into the accounting records those data not subject to objective verification has not deterred his valuable contribution in the preparation of financial plans and other forms of anticipation. This contribution manifestly does not call for the exclusive use of a methodology of refined calculation; necessarily it does rely upon the exercise of professional judgment.

A second important pre-record service of the accountant involves the design and installation of accounting systems. A noticeably increasing amount of the practitioner's time is devoted to the problem of systems design. Because of the uniqueness of the problems associated with an almost endless variety of enterprises, and because *recorded* experience with respect to individual cases in point is often limited or not available, reliance must be had on experience with related or similar businesses. Clearly these responsibilities do not call for an elaboration of specific procedures; rather do they affirm the need for prudent evaluation and election of alternative choices.

Recording. The recording function of the accountant has its beginning with the analyses of business transactions into their debit and credit elements. These analyses presume appropriate *account classifications* and *reliable measurements.* Yet, many transactions do not permit precise delimitation in account categories; nor do they accommodate to scientifically accurate measurement. The measurement problem often requires a determination of estimated collectibility, anticipated future benefit, expected service potential, and a variety of other forms of evaluation. In these and similar instances, the mechanism of double-entry merely provides the form of expression for the accountant's conclusions. The classifications problem poses a comparable exercise in evaluation. It insists upon the selection of useful and descriptive account categories. Herein, a measure of accounting prophecy is required to identify the various users of account information as well as the degree of detail desired by each. The accountant is also obliged to determine the relative importance of specific activities and groups of activities in order to provide necessary and appropriate account descriptions. Patently, reliance must be had on the important judgment of election.

Influences which are often cited as important to these deliberations include the accounting doctrines of *materiality* and *conservatism.* Accounting choice is often explained, or justified, on the basis of relative importance or magnitude. Also other

decisions rest on the potential inflationary effect of choice on reported net income, wherein the accountant, in reaction, is encouraged to eschew any tendency to exaggerate reported profits. These doctrines, albeit operationally effective, require the additional support of other criteria for optimum benefit.

Reporting. To translate account information into useful financial summaries remains a controlling preoccupation of the accountant. It would seem unnecessary to recount here all the uses of discrimination and evaluation in framing financial statements. However, among the more important applications are the determination of amount and form of data required, the extent to which these data may be enlarged or compressed apropos of the user, that information which requires text disclosure and that which may be appropriately presented by footnotes or other forms of appendage, and the character of the statements of previous accounting periods. In reaching conclusions as to these matters, it is again manifestly important to underline the significance of *materiality,* both as to amount and classification. Additionally, the statements should reflect a *consistency* in application of accounting principles, both within the statements and over time. A supporting consideration also of overriding importance concerns the accountant's responsibility to expose the essentials of account data in that form and detail as will promote a clearer understanding in the statement reader. The accountant's determination of the *adequacy of disclosure* requires his acknowledgment of a public responsibility in financial reporting, a motivation to provide unequivocal representation in clear and forthright tone, and an emphasis on substance superimposed on simplicity of form. Surely these influences are not measurable by a proliferation of techniques or procedures, but rather depend upon the exercise of individual judgment, a faculty in aid of discrimination and discernment which is not subject to precise definition.

Analysis and interpretation. The dimensions of the accountant's interpretive function are not well established. However, there is little doubt that they embrace an explanation of directional movement of account data. Traditionally, the accountant has proceeded with post-reporting interpretation by employing conventional analytical mechanisms. Oftentimes the account data are expressed in horizontal format with a consequent measurement and analysis of changes in account balances over time. Interpretation, however, may assume a vertical posture, wherein percentage and ratio analyses have produced rewarding information in the evaluation of current position, asset mobility, equity class interests in earnings, and other significant relationships. Accountants also provide useful interpretive data in financial statement appendages, or supporting schedules. These include analyses of variation in profit, enumerations of receipts and disbursements, statements of provision and disposition of resources, and account analyses.

No implication is made that these are other than the tools of an interpretive methodology; however, the inference is clear that the circumstances which provoke their use and the extent of their application in individual cases necessarily require the reasoned judgment of the accountant.

Present Bases of Accounting Judgment

Much accounting practice is prescribed by administrative edict, regulation or some type of compelling suggestion. Evidence of this is observed in the accountant's virtual inundation by orders and/or recommendations of regulatory agencies, governmental commissions, or professional societies. To the extent that these influences are controlling in other than their necessary, and appropriate, applications, the limits for the exercise of accounting judgment would appear to be confined. However, it must be acknowledged that other influences do give shape and vitality to accounting practice and are necessary parts of the determinants of accounting judgment.

One such influence is the accountant's observable reliance on established precedent. Experiences of the past serve as continual reminders of their relevance to current problems. In consequence, it is not surprising that established conventions, which are the products of reliable judgments of the past, recommend themselves with authority to the solution of present problems. The accountant is also continually reliant on the doctrinal applications cited earlier (conservatism, materiality, consistency, and disclosure). They give direction and purpose, even justification, to his decisions. Of further importance to the accountant's evaluative thinking is his conscious reaction to environmental conditions. Awareness of the economic climate of the business community, an appraisal of nonbusiness influences, and other correlative factors necessarily intrude into the accountant's deliberative processes. Although these influences are an important part of the form and substance of accounting judgment—in greater or lesser degree—they are difficult to identify and even more difficult to measure. Yet, in spite of the importance of these forces, they have not produced a public image of the accountant which gives appropriate emphasis to his exercise of professional judgment. Perhaps some benefit would accrue from an examination of the need for still other bases to support the expression of the accountant's opinion as to what constitutes desirable and appropriate practice.

Influence of Correlative Disciplines

In the interest of promoting wide freedom of election in professional practice, accountants have tended to becloud the dimensions of accounting responsibility. A lack of consensus as to core responsibility or purpose has produced a wide disparity in definition of problems of central importance to the profession. This is not to gainsay the value of wide latitude in exercising professional judgment; rather it merely suggests the compelling need for a measure of agreement as to basic purpose on which to build a superstructure of dependable judgments.

The potential integration of correlative disciplines in the contemplative processes might well be explored more fully. Consider, for example, the possible contributions of logic, mathematics, and statistics.

Logic. Whether or not accounting is a logical discipline need not be considered here; rather it is sufficient to note that logic does have certain properties which recommend themselves to evaluative thinking. Con-

sider the Aristotelian "Laws of Thought":

1. The law of identity: Whatever is, is.
2. The law of contradiction: Nothing can both be and not be.
3. The law of excluded middle: Everything must either be or not be.[1]

These laws appear at first glance to be simple truisms. Yet a sensitivity to them and their value may well encourage greater precision and clarity of definition. Accounting distinctions might be advanced by a conscious recognition of their influence, e.g., as in the case of determining inclusions to income, many of which have a curiously chameleonic character.

The interdependence of accounting theory and practice suggests a further value of the discipline of logic. If judgments that proceed from underlying theory are to possess their intended significance, then attention should be focused on the logical validity of the fundamental reasoning. Logic would not presume to prescribe the basic premises of accounting but only reveal the existence of invalid conclusions deriving from these premises, conclusions which may be emotionally stimulated, externally affected, predetermined, etc. Perhaps the conclusions may still meet the test of usefulness, but their proper basis will be clearly exposed.

Also, it has been proposed that a logical foundation for accounting theory may be delineated via the axiomatic method.

> The intention is not to present entirely new perceptions here, but rather to introduce a new point of view, to clarify old, vague or one-sided ideas, transforming them into logically neat concepts of the greatest general validity, in respect of flow systems.[2]

This method, which employs a list of undefined terms, axioms, and a list of assumptions, or postulates,[3] involving these terms, from which theorems are deduced by the methods of formal logic, offers as yet unexplored opportunity for development in accounting theory.

Mathematics. Apropos of the extensive use of mathematics by other social sciences, it seems particularly appropriate to consider its association with accounting. One point of relatedness may exist in the application of *set theory* to the general problem of accounting classification. This theory has attained a measure of current prominence in mathematics and has been suggested as having relevance to many other fields.

> . . . students who do not plan to be professional mathematicians or philosophers may wonder whether the use of set notions will have the same advantages for them. This is hardly a question to which there can be a single unequivocal answer, but there are affirmative indications. In fact, the development of our whole civilization seems to put more and more emphasis on set thinking.[4]

The concept of *models,* and their expression in systems of simultaneous equations, has also gained current popularity in many social sciences. Professor Richard Mattessich com-

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[1] Bertrand Russell, *The Problem of Philosophy* (New York: Oxford University Press, 1959), p. 72.

[2] Richard Mattessich, "Towards a General and Axiomatic Foundation of Accountancy," *Accounting Research,* October, 1957, p. 347.

[3] Postulation is the adoption of additional axioms within a specific discipline.

[4] Committee on the Undergraduate Program, *Elementary Mathematics of Sets with Applications* (Buffalo: Mathematical Association of America, 1958), p. 2. "A set is just a collection of *things (elements)* from some given 'universe.' . . . The set will have been well defined if, given any thing from the universe, there is (in principle) a way of telling whether or not that thing is a member of the set." (p. 1).

ments upon their applicability to accounting—specifically forecast accounting—using primarily the matrix algebra tool. Although such models are not proposed as general substitutes for traditional methodology, the conclusion is drawn that this approach "may provide a deeper insight into the foundations on which accounting rests."[5] Professor C. W. Bastable also noticed this association and expressed the belief that "there may be a place for model building—that powerful tool in the kit of operations research techniques—in the examination and development of accounting principles."[6]

These are but a few extrapolations of many present applications of mathematics to accounting, which include the use of simultaneous equations, in consolidated statement preparation involving mutual stockholdings, two-variate analysis of gross profit, actuarial computations, and numerous others.

Statistics. The relevance of statistics and accounting is rather generally acknowledged. The acountant has long accepted statistical devices for the collection of economic data; yet, he has hesitated to use many of the projective facets of statistical analysis. Perhaps an exploratory accounting excursion into linear or curvilinear correlation, statistical quality control, or scientific sampling might well reveal important techniques for future accounting application. These tools appear to offer unusual opportunity for disclosing forces underlying behavioristic patterns of business. Present applications in aid of interpretation and analysis of financial statements dramatize this potential.

These areas, suggested as potentially useful in formulating dependable accounting judgments, are but a fragment of those which offer promise of rewarding application. However, the hope is here expressed that these, and other virgin frontiers, will be more completely exploited as accounting acquires more sensitive tools of measurement and analysis. Such reinforcement to his evaluation and appraisal should significantly extend the value of the accountant's professional service.

Conclusions

The complex of activities which are called accounting continually invokes the practitioner's skill and judgment, and his use of traditional methods of accounting investigation suggests a close kinship with the scientific method. Note the appropriateness of accounting inquiry to this method.

> There are certain mental activities which are so absolutely indispensable to science that they are practically always employed in scientific investigations, however much these may vary in other respects. . . . The mental activities referred to are the following: Observation (including experiment), analysis and synthesis, imagination, supposition and idealization, inference (inductive and deductive), and comparison (including analogy).[7]

The importance of judgment in these activities is obvious; however, the accountant is cautioned against an overextension of imagination, supposition and idealization as tending to impinge upon refinement in calculation; likewise, he is importuned to avoid the unquestioning persistent employment of accounting orthodoxy. Professional judgment, founded upon

[5] Richard Mattessich, "Mathematical Models in Business Accounting," *Accounting Review*, July, 1958, p. 474.

[6] C. W. Bastable, "Business Games, Models, and Accounting," *Journal of Accountancy*, March, 1960, p. 60.

[7] *Encyclopaedia Britannica* (Encyclopaedia Britannica, Inc.: Chicago, 1954), v. 20, p. 126.

suitable bases, should assume this equilibrating role.

The published results of a recent examination as to appropriate standards of education and experience for CPAs suggest that the accountant's work is "primarily intellectual in nature and varied in character and requires the constant exercise of discretion and judgment."[8] If the public image of the accountant is to meet the tests of this description, then more voluble expression must be given to the accountant's exercise of professional judgment. In turn the accountant is encouraged to evaluate those areas presently supporting his judgment processes and to seek out additional bases to give greater dependability to his evaluative thinking.

[8] The Commission on Standards of Education and Experience for Certified Public Accountants, *Standards of Education and Experience for Certified Public Accountants* (Ann Arbor: University of Michigan, 1956), p. 2.

PROFESSIONAL EDUCATION

Accountants are busy people, and they face the dilemma of professional people in general. That dilemma is the need for continuous development, and a seeming lack of time and resources to sustain it. But the accounting profession cannot and will not fail to resolve this problem. As a young profession, it has already shown its strength and vigour in the way it has established a reputation for competence and independence in its members. It has an opportunity, now, to reach the forefront of the professions in individual and collective support of a droadening program of continuing education for its members which will extend their development from the day of admission, up to the point where even the most insatiable appetites for learning begin to show a lack of interest in the dessert courses.

Lawrence G. Macpherson, "More Professional Education"
The Canadian Chartered Accountant, December 1959

A Commentary on the present misunderstandings of CPAs by members of the banking profession.

The Banker, The CPA, & The Revolving Door

By Louis M. Kessler

At the last annual meeting of the American Accounting Association, a speech was given by Ralph Curry, novelist (in real life, Professor Albert H. Nadeau). He said, "I am a novelist and according to stereotype I ought to be content with cloistered walls, the hum of my typewriter, quiet conversations with men of letters, an occasional mistress, and an even more occasional royalty. But then, according to stereotype you (the accountant) ought to be content with a dingy office, an adding machine, and a never ending column of figures —no home, no social life, no friends, no sex; just a cold, cold office and columns and columns of figures."

According to stereotype, the banker is a severely dressed individual of somber countenance who can look you straight in the eye and, without cracking a smile, say "No." And, of course, there is the definition of a banker as a man who gives you an umbrella and then wants it back when it starts to rain. I hope none of us are true to stereotype, but unfortunately so much has been written and so many meetings have been held about the banker understanding the CPA and the CPA understanding the banker that I think we are like two people chasing each other in a revolving door. I believe part of the trouble is that we are always trying to convince the other of our own point of view. I suppose I will be guilty of the same thing tonight, but I think we should get out of the revolving door even if we have to back up and start over.

I am here as a representative of the Illinois Society of CPAs, and we welcome the opportunity to meet with bankers who are obviously important consumers of our product and in many cases our best friends. We CPAs cannot advertise—we have no match books to pass out—but in speaking for the entire profession I can ask you to learn more about us and even suggest that you urge your customers to utilize our services. You will do that if you are *sold* on our

LOUIS M. KESSLER is a partner of the firm Alexander Grant & Company. He has long been active in the work of the Illinois Society. He is the present Senior Vice-President of the Society. He also is currently a member of the Executive Committee of the American Institute of Certified Public Accountants. This article is adapted from an address given by Mr. Kessler at the Southern Cook County Bankers Association on February 23, 1960.

services, and to be sold on anything you have to know a lot about it. At the same time, I am sure that we CPAs should learn more about you.

The Marks of a Profession

Third-party reliance obviously includes the granting of credit and is the basic ingredient which commands the interest of the state in regulating our profession. Under our Illinois law, anyone can serve as an accountant for a company, can prepare trial balances and financial statements, and can sign them in this official capacity in a particular organization. But he must not indicate or in any manner imply that the statements or reports have been prepared or examined by, or that they represent the independent opinion of, a certified public accountant or a public accountant. Under our law, the practice of public accounting includes the performance for compensation of professional services that involve or require an audit, examination, verification, investigation, or review of financial transactions and accounting records. It is also defined to include the preparation or certification for clients of reports on audits which are to be used for publication or for credit purposes. One who engages in such professional practice in this state must be licensed as a public accountant, and since 1942, no one can receive such a license unless he first obtains from the University of Illinois a certificate as a Certified Public Accountant.

At the same time, there is and always will be a substantial amount of accounting work to be done by non-CPAs, and our profession at the national level has just reopened the doors to conversation with an organized group of public accountants who are not CPAs. In the January issue of The CPA, John L. Carey (AICPA Executive Director) had this to say:

> "Relations between CPAs and noncertified accountants are a touchy subject, but one which cannot be ignored . . . A basic fact of life is this: in the foreseeable future neither the Treasury Department nor the courts are going to give any group a monopoly of preparing tax returns, doing write-up work, or rendering various accounting services to management. In whole or in part these fields are legally open to CPAs, lawyers, licensed PAs, bookkeeping services, management consultants, and part-time operators variously described. Nothing can be done about it—at least not for a long, long time.
>
> "On the other hand, the courts will protect the title 'certified public accountant' and under regulatory laws will bar the use of similar titles indicating professional qualifications in offering accounting services to the public—with one exception. Persons who have been allowed to practice under the title of public accountant have a legal and moral right to continue to use that title during their lifetime. When a regulatory law is passed, they are enrolled to continue practice as public accountants, but no one else thereafter can assume that title.
>
> "When laws are passed requiring audits, the question always arises as to who should make them. The Institute argues that only competent and responsible persons should be acceptable—and generally only CPAs have formally demonstrated competence by examination."

Under the laws of our state, and as a matter of general business judgment, you should look for audits by CPAs as a basis for loans to your customers. Unfortunately, however, we do not have any rules of professional conduct that apply to all CPAs in this state. It is only when a CPA becomes a member of the state society or the American Institute of Certified Public Accountants that he is subject to rules of professional conduct. As I shall mention later, one of these

rules incorporates the principles of Statement 23 of the Institute's Committee on Auditing Procedure. I think that it is within your province to ascertain whether or not a CPA who signs an audit report for one of your borrowers is a member of the state society and/or the Institute. We hope he is a member of both because the Institute and the state societies work in close harmony, and we're beginning to think, long range, about the possibilities of, for example, common membership.

Statement 23

Let us assume that one of your borrowers presents a report prepared by a certified public accountant who is a member of the Illinois Society and the Institute. I hope that this in itself will serve to give you a more comfortable feeling about the financial statements. The CPA may be presumed to be familiar with Statement 23 since one of our Society's rules of professional conduct (No. 17) incorporates the substance of Statement 23. That statement may be summarized as follows:

(1) A CPA should not express any over-all opinion on financial statements if he has to take an exception of such materiality that the effect would be to dilute his opinion to the point where it has no real significance.

(2) The CPA should not express any opinion if his examination has been so limited in scope that he has no real basis for an opinion.

(3) If the CPA concludes that he is not in a position to express an opinion, he should say so and state why.

(4) If the CPA cannot express an opinion, has so stated and given the reason, he may then incorporate in his report any comments which he feels his examination permits, including comments as to compliance of the statements with generally accepted accounting principles in respects other than those which require him to withhold an over-all opinion.

(5) If the CPA's engagement is the type where no audit is made and financial statements are presented without comment, and if he permits his name to be associated with them, the statements should be clearly marked to indicate that they have been prepared without audit.

Spelling out of Procedures

Your problems are by no means solved when the CPA gives something less than an unqualified opinion, and we could spend the rest of the evening on that subject. But let us assume that our CPA and professional society member presents his report, be it long form or short form, which contains his unqualified opinion as to the fairness of presentation of the financial statements. That means something, and I think, through educational processes, it is meaning more and more as time goes on. However, we find many cases where the banker is not content to read the language, "examination made in accordance with generally accepted auditing standards" and let it go at that. He wants the CPA to spell out many of his audit procedures. Perhaps the fault is ours and of course we have to admit that there are good and bad CPAs just as there are good and bad policemen. But unless there is evidence to the contrary, let us assume that our society member knows what is meant by generally accepted auditing standards, and if he has given an unqualified opinion he has a right to feel insulted if you ask him to spell out the fact that he confirmed receivables or observed the inventory taking. It's like going to your doctor for a physical examination and then asking him to satisfy you that his examination

was proper. Here is a doctor's certificate:

> "I have made a physical examination of Mr. John Jones, age 45. He is a normally-developed, well-nourished man. His blood pressure is 130 (systolic), over 70 (diastolic), his pulse 80 and regular, and his respiratory rate 18 per minute. Examination of the eyes, ears, nose and throat is unremarkable. (This term "unremarkable" has some meaning to the doctors.) The thyroid is not enlarged. Thoracic contour and respiratory motion are normal, and the lungs are clear to percussion and ausculation. The heart is not enlarged, the cardiac rhythm is regular, the sounds are of good quality, and no murmurs are heard. No organs, masses or fluid are felt in the abdomen, and a hepato-jugular reflex is not obtained. The remainder of the physical examination, including a neurologic survey, is normal or negative. I believe Mr. Jones to be in good health."

This "certificate" might be something between the long-form and the short-form report. The doctor might say, "You're O.K., come back again in a year," or he might write a special report of several pages. Ordinarily, we do not inquire into the doctor's methods as to just how he performed his examination. We are interested in his opinion and we like to feel that we have confidence in him.

Regarding the CPA's opinion, if there is an understanding as to what is meant by the term "generally accepted auditing standards," I see no reason for spelling out some of the procedures, such as: "We verified the above bank balances with certificates received directly from the depository banks, and we counted the petty cash on December 31." (Incidentally, the "above balances" might be a listing of Bank A, regular account and payroll account; Bank B, Bank C and petty cash.) I can think of one obvious reason why bankers would like to see a listing of the bank balances in order to know with whom the customer is doing business, but it seems to me that it is a little "sneaky" to get this information from the auditor. Cash should be accepted as cash the same as the item "cash and due from banks" appearing in your own statements of financial condition, and there is no real increment in disclosure as to financial position by detailing the make-up of the cash accounts.

Then as to other comments: "We have determined that the amount shown as trade accounts receivable is represented by individual customers' accounts," followed by a description of the usual confirmation procedures. Then, "the collectibility of the accounts was discussed with Mr. John Jones, President of the company, and we concur in his opinion that the allowance for doubtful accounts is adequate to cover probable losses from bad debts . . ."

"We made sufficient physical tests of inventory quantities to satisfy ourselves as to their general accuracy, and we tested prices, extensions and footings sufficiently to satisfy ourselves as to the valuation of the inventory as a whole. We obtained from Mr. Smith a signed statement indicating that in his opinion the inventory has been properly valued."

"As to prepaid insurance, we satisfied ourselves that the calculations made to prorate the expense are substantially correct. Details of life insurance policies were confirmed to us by the companies."

"We have vouched the additions to fixed assets and are satisfied that they represent proper capital charges. We have checked the calculations of depreciation for the year. We ascertained that the total of the accounts payable is the aggregate of the trade accounts recorded on the books. We

satisfied ourselves as to the various accruals. Details of the mortgage have been confirmed to us by the mortgagee. We obtained from responsible officials a signed statement that none of the assets have been pledged except for the real estate mortgaged, that no lawsuits are pending, and that all known liabilities have been recorded,"—and so on and so on.

These and many other procedures are encompassed in the term "generally accepted auditing standards."

I have with me a detailed audit program, including a program for cash and tests of transactions. I am sure you would not want the CPA to reproduce in a long-form report his entire audit program. In the words of Milton J. Drake, past president of the Robert Morris Associates, "the banker should be able to rely on the accountant having followed all of the procedures appropriate to the particular situation and expect that any exceptions have been disclosed clearly. The banker also should be able to rely on an unqualified opinion meaning what it is presumed to mean according to the standards of the Institute, as well as expecting a qualified opinion to be given when called for."

Disclosure

Another subject on which we could spend the entire evening is what information should be in the auditors' report. I think I have made it clear that I do not believe that audit procedures should be spelled out in the report except for situations which vary from the uniqualified opinion.

As to other disclosures I feel that the term "fairly present in accordance with generally accepted accounting principles" covers much of the information that the banker justifiably feels he needs, but it should be in the statements themselves and the notes thereto and not necessarily in a long-form report. I am referring to such items as:

- Basis of inventory valuation and some breakdown of inventories.
- Basis of carrying fixed assets, some breakdown of fixed assets, and significant differences, if any, between tax and accounting depreciation.
- Secured liabilities and assets subject to a lien, if any.
- Significant provisions of term loan agreements, and retained earnings restrictions, if any.
- Analysis of changes in capital accounts.
- Situation regarding examination of income tax returns.
- Significant post-balance sheet events, commitments, and contingent liabilities, if any.
- Changes in accounting methods, if any. (Obviously, if there have been any significant changes the auditors' report should be qualified as to consistency, and the effect on the current statements should be disclosed.)

All of the foregoing can be covered in the opinion, the basic statements and the notes to financial statements. Then if supplemental statements are added, such as cost of goods sold, selling and administrative expenses, condensed comparative statements, fixed assets, insurance coverage, and changes in working capital (source and application of funds), the banker has practically everything that we are so often told he wants—with one major exception—age of receivables. This can also be furnished in a supplemental statement or furnished separately by the client or by the CPA, the CPA were aware in advance of the special needs of a particular bank, he could include such schedules during the audit at a minimum of expense.

and we still don't have what I think of as a "long-form report." In other words, we don't have several pages of stereotyped text material.

I have not mentioned many specialized subjects, such as cash-basis statements, non-profit organizations, contractors' accounts, tax liabilities of partnerships and proprietorships, but obviously we can't discuss the whole gamut covered by the AICPA bulletins, Regulation S-X of the SEC, and other pronouncements on accounting principles and procedures and matters of disclosure.

Last month the local Robert Morris committee on cooperation with CPAs met with the Illinois Society's committee on cooperation with bankers and other credit grantors. This is progress, and it may help us get out of the revolving door. But I notice that in one question the bankers say, "Rarely do we feel that any prepaid expense deserves the designation of a current asset." We've been all through that. I refer you to Accounting Procedure Bulletin 43 and to Question 39 in the publication, "40 Questions and Answers About Audit Reports." I don't propose to argue the question here, but why not leave the resolving of this kind of an accounting question to the accountants.

Getting Out of the Revolving Door

How do we go about getting out of the revolving door? One way, of course, is to have more meetings like this, and of course the committee meetings just mentioned.

In the preparation of Bulletin 9 in the Institute's series on Economics of Accounting Practice, personal interviews were conducted among the chief commercial loan executives of 100 banks—large, medium and small in all parts of the country. Much is being accomplished to generate better understanding, but as the report says, "in the final analysis, it is the interaction of individual CPAs and bankers in their day-to-day working activities which provides a true test of the CPA-banker relations." Lack of personal contact was underscored in the survey when the bankers were asked to estimate the number of CPAs whom they knew and the total number of CPAs in their community. About 40 of them had a reasonable idea of the number of local CPAs. About 15 would not hazard a guess. All but four of the remaining bankers grossly underestimated the CPA population in their communities. As might be expected, bankers in smaller cities were usually more accurate in their estimates and were familiar with a higher proportion. But even here, the response was erratic. It was not uncommon for bankers in large cities to know personally less than 15 CPAs.

The bulletin says that bankers frequently complain about the inadequacy of some reports for their needs. Yet the accountant is rarely called in when discussions with the prospective borrower take place. The banker usually describes what is wanted to the borrower and the accountant hears of it second-hand. After the report has been submitted, it is not uncommon for the banker to feel he must check with the accountant for clarification or additional information—and this may require additional work at an additional fee. Although some of the reports may be inadequate for credit purposes, a number of bankers fail to realize that some of the requested information is not normally acquired in the course of a regular audit. If

The report also mentions these adverse comments about the CPA:

(1) He has a too narrow view of his own function.

(2) He forgets the needs of a bank for credit information and fails to supply sufficient detail, particularly in terms of comparative data for prior years.

(3) He is often too preoccupied to offer a creative service to his clients—thus confirming a widely held belief that he is merely a "necessary evil" imposed on a business by interested outsiders.

(4) He is not insistent enough in convincing his clients of the value of a "complete" audit which would justify an unqualified opinion.

(5) He is sometimes inclined to sacrifice his objectivity to the wishes of his clients.

The authors say that these are obviously serious charges. If any CPA is guilty of them, he ought to reform; but if he feels—as many CPAs have a right to feel—that the charges are too severe, then he has an equal obligation to enlighten the banking executives in his community.

The bulletin points out that both CPAs and bankers are concerned with promoting the economic health of the business community. Because of their common aim, they ought to understand each other. That understanding is important not only in terms of the welfare of their mutual clients; it is important, too, in advancing the self-interest of each group.

And, of course, there is the age-old problem of convincing the client that he should pay for good accounting services. I can never forget a sign on the wall in front of a dentist's chair in the small town in central Illinois where I grew up. You might say it was "drilled into me." It said, "Cheap dentistry is worthless dentistry. My terms are cash." Convincing managements of small business that good professional accounting service is well worth its cost is something that both of us will have to work on for a long, long time.

A few months ago, this statement by John Carey appeared in the Ohio CPA:

> "There is a gradually increasing acceptance by the larger banks of the assumption that financial statements certified by CPAs are an indispensable requirement of bank credit. It seems to be inevitable that the smaller banks in the smaller communities in time will follow suit. Bank officers and directors take a certain amount of risk in failing to take advantage of all available safeguards in utilizing their depositors' funds and in their stewardship of the stockholders' capital. By educational processes, CPAs can do something to accelerate realization on the part of banks that the independent audit by a CPA is becoming a standard, accepted safeguard."

I think our revolving door dilemma was well stated a couple of years ago by Arthur L. Nash, representing the Robert Morris Associates at a meeting with bankers sponsored by the Rochester Chapter of the New York Society of CPAs:

> "There continue to be, and probably always will be, complaints from bankers that some CPAs have not complied with standards of adequate disclosure in the financial statements and accompanying audit reports. On the other hand, accountants may complain that some bankers do not fully understand the standards of the accounting profession or the nature of the CPA's relationship with his client."
>
> Mr. Nash goes on to say, "Unless those of us in the banking fraternity who interpret audit reports and who must discuss them with clients (and, on occasions, with auditors) have a clear understanding of auditing standards and pro-

(continued to page 35)

Excerpts from the featured speech presented at the Awards Dinner of the Society on April 21, 1960.

What Is Your Name?

By Willis D. Nance

Many old Roman maxims and slogans have come barreling down the centuries to remain as pertinent and true in the Mid-Twentieth Century as they were in the days when Rome ruled the world. One of these old Roman maxims which has always interested and intrigued me is *"Sine nomine homo non est!"* Freely translated this Latin phrase means "Without a *name* man is nothing!"

Most of us do not realize that our name is closer to us than anything else. A man's name stays right with him throughout his entire life. A man's name goes with him everywhere, at all times, from the cradle to the grave. Even after he dies his name is the one thing that remains. A man may change his name but he never loses his name.

A man's name is his most prominent feature.

A man's name is the distinguishing appellation by which a person is known.

A man's name is the most efficient way of describing him to contemporaries.

A man's name is his most permanent possession; it remains when everything else is lost.

A man's name is owned by those who possess nothing else.

A man's name is his signboard to the world; his report card to his friends and contemporaries.

Today each of us has at least two names. Our surname we inherited from our father and grandfather. Our Christian name was bestowed upon us by our parents at birth. We had nothing to do with the choosing of our names. We have to take the hands which are dealt to us in this matter, for babies cannot be choosers. But, nevertheless, the name you carry with you through life is like a sheet of paper on which you are privileged to write almost anything you like.

If you will, you can pack that name of yours with content until it will stand out with an individuality and importance all its own. Because a

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man's name is inseparably connected with his life, the building up of a man's name is one of the most important processes in life. In building up his name he is at the same time building a useful and worthwhile life.

If you would "build up" your name, first devote your energies to building up a sound and reliable physique which will stand the wear and tear of all those exacting years of maturity in business or in a profession. To do this is not the work of a day or a week—it is the work of years of clean, vigorous, happy living.

The second part of this building-up process is the building up of a mind with the necessary fiber, grasp and imagination to make it adequate to meet all the demands which are to be made upon it during your entire life. As a 19th Century Philosopher has so aptly put it, "The mind is like the stomach. It is not how much you put into it, but how much it digests."

To do *this* is a task which will occupy all of your waking hours for at least forty years. If you are successful, you will have the pleasure of enjoying a well-ordered and well-trained mind for the balance of your lifetime.

The third part of the process of building up your name is to build up your character. To do this is a job for a lifetime.

Every man can develop character of the highest type if he but has the will to work at it. If you are successful, you will have accomplished the ideals you cherish, the high purposes you hold, and you will have built up a capacity for something finer than anything that you have yet attained. And there is no more appropriate time than tonight to appraise just what you are going to do about this third step in building up your name.

Tonight as you receive your certificate as a C.P.A.—you become a member of a profession—you become a professional man rather than a mere business man.

There are a number of definitions of the word "profession" and all of them are very much alike. The definition I like best is the one credited to Justice Louis Brandeis, one of the most outstanding justices ever to sit on the United States Supreme Court, who defined it this way—"A profession is an occupation requiring preliminary intellectual training, pursued primarily for others and not merely oneself, and accepting as the measure of achievement one's contribution to society rather than individual financial reward."

Little need be said with respect to intellectual training as applied to you who are here tonight. It is my understanding that approximately 75% of CPAs are college graduates. In addition, each of you has passed a difficult examination prescribed by public authorities, and the very fact that you have received your CPA certificate is proof positive that you are assumed to have a degree of competency not shared by others in the accounting field.

In this highly complex society of ours in this Mid-Twentieth Century, persons who do the most for others are rewarded with the greatest honors. Public respect and admiration are won solely by service to the public. Professional men are regarded as public servants and, therefore, are accorded a measure of public respect greater than that given to persons who are known to be working only for their own enrichment.

The acceptance by a CPA of this responsibility to the public means that he is accepting the obligation to serve

hers as a primary duty and that he willing to face the fact that finanal gain is to be relegated to second ace. As a matter of everyday prac:e, it means that you may be reiired to renounce many of the prac:es that are acceptable in business it which, if carried over into profesonal practice, would tend to make it distinguishable from business and ould impair the integrity and indendence of professional service.

A recognized profession is peritted to acquire an exclusive franise in the field of work in which it identified only because the public pects professional men to be men competence, of independence, of tegrity, men who are willing to put rvice in the public interest as the st requirement of their professional actice.

It is principally what a man *does* ther than what he does not do that velops his name.

You sometimes hear it said of some lerly gentleman who has just gone his reward: "He was such a good an. He *never* drank; he *never* noked; he *never* swore; he *never* jured anyone, and we *never* heard m speak an unkind word of anybody his life," and when that list of gative virtues is completed, you ve the picture of a life as harmless a butterfly. What you have is a never" man. Don't be a "never" an—*never* doing this and *never* ing that—*never* doing anything!

With respect to the elderly man I ve just described you are immeately moved to ask, "But what did he do?" How did his life count for good in his family, in his profession, in industry, in politics, in promoting better conditions in his community? If he simply refrained, his life and his influence on others was weak and thin.

Our lives, yours and mine, leave an impact upon our fellows that reaches far beyond the horizon of our knowing. A little of ourself rubs off each time we make contact with another person.

We are not ciphers; we are pluses or minuses; we give or we take away. We make the world better or worse simply by living in it.

In the last analysis, the most essential thing in building up and developing your name is to learn how to live—how to live with others and how to live with yourself. It is by that process that you build up your character and individuality, and your personality is developed, matured and enriched.

As you go forth tonight as new men, new professional men, to practice your profession and engage in the everyday activities of your life, set your mind and heart upon these objectives. A gratifying reward will be yours if you devote your best energies and your best hours to building up your name.

At the beginning of this discussion I referred to an old Roman maxim. In conclusion I return to it: *"Sine nomine homo non est!"* "Without a *name* man is nothing!"

What is Your Name?

The unique opportunities and responsi
bilities of the accountant in assistin
management with the most vital of a
business decision areas—planning

Accounting fo
Management Planning

By P. F. Loren

As a result of the work done by many groups in the accounting profession, we have in the United States today a set of accounting principles and practices that have become accepted as the "ground rules" by which the financial results of a business enterprise are evaluated. Many of these accounting principles are as readily accepted by business management today as some of the rules of business law that have lived for centuries. Yet most of these accounting rules have been developed and codified within the last forty years.

Accounting reports have become the established framework of a sound management control system of a business enterprise. But to be useful, these reports must be designed to serve two distinct phases of management control. The difference between the two types of control can be illustrated by a familiar analogy—the similarity between the management o
a business and the operation of a shi
Two basic types of management r
sponsibility are more clearly evide
in the operation of a ship than th
are in the management of a bu
ness. The first and more common
recognized type of management r
sponsibility is operating control—t
immediate direction of day-to-day o
erations. This type of control is sin
lar to the control exercised on a sh
by the helmsman at the wheel, w
takes his orders directly from the ca
tain. The second type of responsib
ity in business management is pla
ning control—or the direction of ma
agement decisions toward long-run o
jectives. This type of control corr
ponds with the responsibility assign
the navigator of a ship, who must l
out, under the direction of the sk
per, the proposed course of the vo
age.

PAUL F. LORENZ is the Executive Assistant to the Group Vice-Presid
of the Car and Truck Division, the Ford Motor Company. This art
is adapted from an address given by Mr. Lorenz in Chicago on Novem
4, 1959. This was one of a series of five lectures sponsored by
University of Chicago in cooperation with the Illinois Society of Certi
Public Accountants and the Chicago Control of the Controllers Instit

he Accounting Function

The important role the accountant lays in providing management the eports that are needed for immediate perating control is well understood. uring the past thirty years, the in- egrated system of operating reports hat have been developed and super- ised to a great extent by the account- ng profession have become the vital ontrol tools used by every line ad- ninistrator from foreman through resident. These reports constitute ne channel of communication and ontrol that runs from every area of ne business to a central administra- ve office, in a manner similar to the ntricate communication system of a nodern ship that links each vital peration, from radar tower to engine oom, to one central "information enter" where the captain can see at glance the status of every phase of ne ship's operation. Without this laborate communication system, no hip could exceed in size the range of ne human voice. In like manner, our nodern industrial complexes are being oordinated through the operating and nancial reports that have been devel- ped by the controllership function f business. Through the improved ontrols provided by better reporting echniques, the accounting profession as been raised from a score-keeping esponsibility of recording history to he new and vital controllership func- ion of providing management with ll types of data needed for operating ontrol of the enterprise.

lew Challenges

In recent years, the accounting rofession has been confronted with new challenge—the development of eports specifically designed to control the planning phase of business management. This "'new frontier" of accounting is just now opening up, because industry has just begun to see the need for better forward planning, particularly better financial planning.

As the speed of technological and social change accelerates, the planning phase of business management will become increasingly important, and the accountant must have available the control mechanisms required to serve this distinct phase of management responsibility.

All of us are aware of the tremendous rate of technological progress that has taken place in the last ten years in such fields as electronics, nuclear energy, and missile guidance. These advances in the scientific field are so dramatic, however, they sometimes overshadow the degree of change that has taken place in the more commonplace consumer goods such as housing, autos, TV, cameras, hi-fi, and many others. This accelerated rate of change in practically every industry in the last ten years has had a far-reaching effect on a dimension of business management not often given separate consideration — the dimension of *time*.

In the last decade, the dimension of time has changed almost as much in the field of business planning generally as it has, for example, in the field of air transportation. Change, a function of the time dimension, has always been with us; the important new development has been the rapidity of change as it relates to shortened product life, rapid technological obsolescence, and sharp shifts in consumer demand. Paradoxically, the same forces that have *shortened* the life cycle of any specific product or proc-

ess have *lengthened* the time period over which sound management planning must extend.

The adaptation of traditional techniques of navigation to air transportation provide a good illustration of the effect of a shortened time dimension on the range of planning. Under the classical "Bowditch" technique of navigation, the navigator on an ocean voyage usually enjoyed the luxury of adequate time to calculate precisely the position of his ship once he had gotten a sighting from the sun or stars. Ordinarily, he did not have to be concerned about the slight deviation from course that could develop between his "sighting" and the completion of difficult mathematical calculations required to establish the ship's position. How different is the responsibility of the navigator on a 7-hour jet flight over the Atlantic! His entire attention must be concentrated on trends and projections, and a navigational "fix" to be useful at all must be calculated ahead of time for mere verification as a predetermined check point. The predictability of future position is becoming the primary objective of flight navigation, and most air traffic control techniques are being designed to serve this objective. By extending the range of planning and air traffic control, the risks and uncertainties of air travel are being continually reduced.

The Current Economic Scene

In modern business as well, the range of planning and control must be extended if we are to minimize the risks and uncertainties of an economic environment in which progress is generally measured by the rate of change. Winston Churchill is quoted as once saying, "To change is to improve, and to change often is to become perfect." We have reached a stage wher the terms "new" or "improved" o "different" have become the magi challenge of success. In certain styl items, notably women's fashion good "change for the sake of change" i a major stimulus—even when th change may seem to be a retrogres sion or actual inconvenience, viz pointed shoes. Yet in most function items, whether consumer or industria goods, the Churchillian principle usu ally applies—"to change is to im prove."

The primary stimulus for chang in today's economy results, not fro any irrational desire on the part o the American businessman to discar the past, but rather from the rapidl changing character of the market fo consumer and industrial product In a recent article on the "Mark of the Sixties," *Fortune* magazi summarized the expanding scope o the changes we can expect in the ne ten years in our economy as follow

> "During the Sixties, our populatio increasing at the rate of approximate three million per year, will add the equi alent of a city the size of Phoenix, A zona, every month. . . .
>
> "Today, over 90,000 Americans mo every day. By 1970, one out of eve four—more than 50 million—America will change addresses every year.
>
> "Between now and 1970 . . . discretio ary income will just about double . . from $135 billion to some $255 billio
>
> "The dominant characteristic of th Market of the Sixties will be wider choi and diversity, not uniformity.
>
> "The American people . . . seem like to intensify and accelerate the swings fashion and fad and to enhance the d mand for the uncommon or unusual du ing the next decade."

Management planning for the Si ties must take account of the exte to which the accelerated rate

ınge in our economy increases the k element of a business venture.

. The shortened life expectancy of new products, coupled with an extended development period, multiplies the risks involved in waiting to copy a successful move of competition.

. The increased complexity of new products and processes has lengthened the research and development period required to incorporate improvements.

. Heavy expenditures for engineering, tooling, and facilities must often be committed well in advance of the time the product can be made available for actual competitive evaluation by the consumer.

. Marketing strategy or sheer facility limitations may require that a new, untried product ''push out'' the older, accepted and often successful product it is designed to replace.

. Substantial sums must sometimes be committed on alternative, or even duplicate, programs solely as insurance against the unpredictability of market trends.

Management in the auto industry become acutely conscious in recent rs of the nature of these risks and extent to which they are increas-. The auto industry, for example, introduced more major changes l new product offerings in the last r years than in the preceding ten rs. Yet, the degree of product lution in the auto industry in ret years is slow compared with the ances that have been made in tronics, missile, and aircraft instries.

Any increase in the ''product turnr'' rate of an industry, so characistic of modern business, tends to rease the investment risks of that ustry. As an illustration, the three gest firms in the auto industry rged off a total of $2.7 billion, or roximately $700 million annually, ing the four years 1955-1958 in form of tooling amortization alone, excluding depreciation charges on plant and equipment and huge sums spent on research and engineering costs. These tooling write-offs were double the charges reported in the period 1951-1954, and four times the tooling costs reported for the years 1947-1950. Practically all of the tooling expenditures recovered through these write-offs were committed and spent before the first unit for which they were built had been produced. The development of jet air travel involved similar commitments of huge sums for research engineering, testing, and tooling and preproduction costs, years and months in advance of any opportunity to test, in actual usage, such factors as differential fuel costs, utilization rates, gas and payload limits.

Projections: Need and Uncertainty

To an increasing degree, the success of a business enterprise is dependent upon the accuracy of projections of revenue and cost factors that are made months and years in advance of actual production. And, in many instances, these revenues and cost factors cannot be changed materially once production has started.

The management of a modern business must take the dual gamble of guessing correctly months ahead of production, not only the exact character or type of new product the consumer may buy, but, in turn, the probable revenue, cost, and profit position of the product at a wide range of possible sales volumes. A mistake on either count can prove fatal. Unfortunately, these increased risks have not been compensated for through higher profits for industry. Corporate profits, expresed either as a per cent return on sales or invest-

ment, have declined steadily through the period 1950-1958. American industry has somehow gotten into an odd roulette game—the entry fee is constantly going up, and the pay-offs are getting smaller! Yet, ironically, the outside investor (the pari mutuel player) has bid up price-earnings ratios for most stocks to an all-time record!

There is a partial explanation for the seeming paradox of declining earnings and higher price-earnings ratios. Corporate profit margins have been declining because of the cost-price squeeze of inflation while depreciation charges have risen to the point where they currently amount to 80% of reported profits after taxes. As Standard & Poor's recently noted, total cash flow has become a more significant measure of the financial position of the enterprise than the profit figure.

Certain industries have been more successful than others in reinvesting the higher stream of cash flow in projects that increase the utilization rate of the capital employed in the enterprise. Once again, we have in modern jet transportation a dramatic illustration of the relationship between capital utilization and the dimension of time. In one 26-hour period recently, a single 707 jet plane carried a total of 416 passengers in a series of flights from New York to Los Angeles, Los Angeles to Chicago, Chicago back to the West Coast, and back east to Boston. In holding to this schedule, this one plane generated over $50,000 of gross revenue in 26 hours—certainly a high rate of revenue generation even for a piece of equipment costing $5,000,000.

This remarkable utilization rate of speed jet aircraft had been predicted some years back, however, when a major airlines decided to procee with the tremendous expenditures i volved in converting their slowe piston-engine fleets to jets.

Modern management is bein judged to an increasing extent by t skill it shows in making this type decision on a timely basis. No long is it sufficient for a management show an adequate profit for la month, last quarter, or last yea Wall Street long ago learned to adju stock prices to projected earnings f next year, and, more recently, vestors have placed increased emph sis on the "growth" or future ear ings potential of the business five a ten years hence. "Growth" stoc have become the glamour ventures Wall Street, even though the exa definition of a growth stock is st in dispute. One more definition mig be offered for consideration. A grow enterprise is one in which adequa funds appear to be available for investment by a management gro that has already demonstrated ability to recover and reinvest ava able funds into new and profita operations. As a result of their s cessful reinvestment policies, grow stocks, almost by definition, have low dividend pay-out ratio, and attractiveness of a growth vent appears to increase as dividend yi goes down.

Quite often a wide variation tween the price-earnings ratios of companies in the same industry i direct reflection of the confidence investors in the relative ability of two managements to guide availa capital into successful and profita ventures in the future in the sa manner as in the past.

The recent market behavior of

in "growth" ventures confirms the pothesis that one of the primary sts of sound management in a owth industry is its ability to accu-ulate and direct resources to profit-le uses, thereby increasing the total lue of the enterprise. Within this finition of resources, we must in-ıde engineering, manufacturing, d marketing skills along with the iversal financial commodity of *oney*. The efficient utilization of ailable funds or *money* represents e of the greatest challenges of mod-n business management, and it is this area where the accountant pro-des his greatest service to manage-ent.

American industry has invested 50 billion in plant and equipment the last ten years, not including e tremendous sums spent in engi-ering, product research, etc. The eer magnitude of these capital ex-nditures has forced increased em-asis on the investment responsibil-y of management. For, as one rewd financier once put it, "There e times when it is easier to make oney than it is to spend it wisely." ost firms have long since become vare of the extent to which the vestments they made in the early ifties established the foundation for e operating results of the last few ars. In turn, the investment deci-ons made this year will form the ise for the financial statements pub-shed in the early Sixties.

These investment decisions consti-te the "bridge to the future" for ıy given business firm but, in many stances, their soundness can be easured only through the passage time. For rarely does a firm enjoy e continuity of management neces-ry to apply hindsight accountability for major errors in investment plan-ning. A series of poor investment decisions can soon lead to an "inver-sion" of the assets of the firm by freezing funds in low return or loss operations with little or no profit or cash recovery. Successful manage-ment must develop the judgment, technical skill, and financial controls necessary to prevent such diversion and stagnation of funds into low-return ventures.

The Needs of Informed Management

The efficient *utilization* of all avail-able funds, therefore, has become a primary responsibility of modern management. Our system of private enterprise has always held manage-ment responsible for the preservation and use of assets, but the accelerated rate of technological obsolescence in recent years has placed a new empha-sis on the *turnover* or recovery rate of those assets. This "roll over" con-cept of investment management, em-phasizing maximum utilization of funds, has already been reflected in the growing practice of leasing, rather than owning, real estate and equip-ment and, in some instances, the financing of inventories and receiv-ables. In following these principles, many firms deliberately divert funds from low-risk, slow-turnover invest-ments in real estate to high-risk in-vestments in new product development and market expansion. The resulting increase in the turnover of funds puts added pressure on management to speed up its "investment decision" or planning responsibility, and ade-quate reports and analyses must be available to insure these decisions are made wisely.

In many areas, this emphasis on

capital turnover has reached the point where it has been directed to the return *of* the investment, rather than the traditional concept of a return *on* an investment. This "cash flow" recovery process has been likened to the "caterpillar tread" of a tank in the following ways:

1. It makes its own roadbed over a "rough terrain," such as a recession.
2. It provides the opportunity for quick readjustment to market trends through redirection of the "track" flow.
3. It establishes its own rate of progress by the speed at which the funds, or treads, are "picked up" and "put down"—if necessary in a changed direction.
4. It grinds to a halt whenever the "treads," or assets, become frozen in nonprofit ventures.

This cash flow concept of capital management has significance well beyond the accepted "cushion" it provides to cover dividend payments in periods of low earnings. It is also a measure of the rate at which management has the power to redirect the resources of the enterprise into *new* areas of investment. This principle of recovery for redirection represents quite a departure from the traditional concept of "dedication of assets," in which the term "dedication" carried a connotation of finality equivalent to the marriage vow. Yet in today's era of rapid change, a successful investment must often be measured in terms of the rate the funds are returned for possible use elsewhere.

This emphasis on the "recovery rate" of funds and the pressure to increase the utilization rate of capital has been brought about, in part, by the shrinkage of funds that are available from *retained* earnings discussed earlier. As earnings decline, management must be more selective in the reinvestment of funds generate *within* the enterprise by being mor demanding in its standard of recov ery rates. The accounting professio has already begun to recognize thi changing concept of investment plan ning through such changes in accoun ing principles as the recent liberal zation of rules relating to depreciatio allowances, which recognize the shor ened economic life of many capita expenditures.

The Accounting Reports

As noted earlier, the controller c accountant in industry has the pr mary responsibility for designing t reports and conducting analyse needed to improve the caliber of firm's investment decisions. The are at least four specific ways in whic this responsibility can be discharge through:

1. Improved financial analysis of inves ment alternatives, including:
   a. Systematic screening of all inves ment decisions.
   b. More accurate measurement of t *rate* at which funds are likely be recovered.
   c. Better evaluation of the "range risk" factors of each investme alternative.
   d. Improved techniques for evaluati the projected financial result each investment project.
2. Establishment of definitive physic and financial objectives for each m jor investment decision.
3. Development of formal "*status r ports*" that can measure, at freque intervals, the progress being ma toward the established product a financial objectives of a venture.
4. Development of improved *financi forecasts* that:
   a. Extend through the entire critic period of management planning.
   b. Incorporate the current status *all* projects or commitments th will affect the future financi statements of the enterprise.

Great progress has already been ıde in the first area of responsibility the financial analysis of proposed vestments—as a result of the tech- al refinements that have been intro- ced in recent years in the theory capital budgets. More work may needed, however, on the manner in ich some of these theoretical prin- les are applied in the practical aluation of specific investment al- natives.

As an illustration, let us assume at management must choose between o new product ventures, both equal terms of their uncertainty as to nsumer acceptance or product life. ıch will require the same initial vestment, and each is expected to nerate the same annual revenue. ıe major difference between the two ojects is the form of the initial fixed vestment.

In this hypothetical example, we have a good illustration of the difference between the "roll over" or cash recovery measurement of an investment and the accounted profit measurement as reported on the financial statement.

At the end of three years (which we assume to be the expected length of the product cycle) Project A has an accounted profit after taxes of $600,000, or some $300,000 less than Project B. In terms of funds recovered for reinvestment, however, the less profitable Project A has returned $300,000 *more* cash flow to management for reinvestment and may prove more attractive to a "capital hungry" growth enterprise.

Whether Project A or Project B represents the better investment for a given firm will depend on such factors as the nature of the industry,

Alternative New Product Ventures

	Project A	Project B
itial "Fixed" Investment		
Capital Investment in Land, Bldgs. and Equipment	$ 300,000	$ 1,200,000
Tooling Expenditures	1,200,000	300,000
	$ 1,500,000	$ 1,500,000
ojected Revenue, Cost and Profit (First Three Years)		
Sales ($5.0 Million Annually)	$15,000,000	$15,000,000
Gross Margin (33%)	5,000,000	5,000,000
Selling and Admin. Expense	2,500,000	2,500,000
Gross Cash Recovery	$ 2,500,000	$ 2,500,000
Non-Cash Charges		
Depreciation (10% Annually)	90,000	360,000
Tooling Amortization (3-Year Write-off)	1,200,000	300,000
"Accounted" Profit *Before* Taxes	$ 1,210,000	$ 1,840,000
Profit After Taxes (50%)	$ 605,000	$ 920,000
ınds Available for Reinvestment		
Profit *After* Taxes	$ 605,000	$ 920,000
Non-Cash Charges	1,290,000	660,000
Total	$ 1,895,000	$ 1,580,000
Unrecovered" Investment (End of Third Year)	$ 210,000	$ 840,000

the investment policies of the particular firm, and the likelihood of a repeat cycle of the product involved. Regardless of these other factors, however, the application of conventional accounting principles to each venture will result in a higher tax charge for Project B in the first three years than for Project A. This same difference in cash drain for taxes will exist regardless of whether the two ventures are compared on the basis of a complex formula using a discounted cash recovery or through the oversimplified comparison shown in the table above.

We might well ask, however, whether there is any real difference between the two ventures, except for the conventions used by accountants in writing off the initial expenditures involved? If both products have a probable economic life of only three years, is it reasonable to have any "unrecovered" investment in either venture at the end of that time? To be sure, the buildings and equipment may still be sound, but how certain can we be that they will have any economic use?

Depreciation Practices

In developing projections of accounting revenue and cost, financial comparisons of the "pay-out return" for high-risk investments may have to be made independent of the conventional accounting treatment of depreciation and amortization rates. Proper evaluation of the profit potential of a short-term venture may dictate the use of accelerated write-off of all fixed costs associated with the project, regardless of the normal distinction between short and long-term asset valuations. In effect, such accelerated charges discount future profits of the venture at a high rate by measuring the recovery rate on the basi of total initial expenditures, regarc less of the type of expenditure ir volved. Unfortunately, the resultin pay-out rates will not reflect the ever tual realities of actual net cash re covery, because tax rates and dividen ratios will probably be dependen upon the conventional treatment o amortization and depreciation cost In the long run, our accounting co ventions must be adapted to the real ties of technological change rathe than the traditional application o formula depreciation rates.

The Accountant And A Dynamic Market

To a greater degree than in th past, the accountant must determin more precisely the total "range o risk" of each venture in terms o product and market trends as well a cost-price relationship. This involve consideration of such factors as:

1. What is the likelihood of substitutio between the proposed product an similar offerings of the firm?
2. What is the lowest reasonable limit o incremental profit that can be expecte from the venture?
3. To what degree are the facility inves ments "flexible" and capable of bein diverted to other uses?
4. To what extent can the initial com mitment be minimized until the prol able success of the venture can l more accurately determined? Will a "advanced grant" of funds allow th project to proceed without loss o time?
5. Are the revenue-cost projections likel to change as a result of:
   - Shifts in market demand?
   - Price trends in the industry or i flation?
   - Increased competition as compet tors adopt new techniques?
   - Foreign competition?
   - Spreading cost differentials by ge graphical area?

- Inadequate data on future design characteristics?

1. Have adequate funds been provided in research and development to minimize the risk of failure?

As a minimum, each such venture ıst be measured on the basis of both rremental and accounted profit. The culation of "incremental" profits ıst take full account of possible ernative uses of the resources asned to be idle or available in the rremental analysis.

Substitution and incremental profit ıst be calculated, moreover, not ative to the present, but relative a projection of market conditions ely to exist at the time of the new oduct introduction. This is espelly important in a situation where firm has been steadily losing comtitive position—incremental investent may be required merely to arrest e decline, i.e., the firm may have to n just to stand still. In this situan, the investment would be justid even though there appear to be tle or no "incremental profits" lative to the present.

Such projects should, however, be w and far between in a healthy terprise. Too often they reflect a speration decision that no alternare is available, when more careful alysis would have revealed numers other, and possibly better, alternaes. The lack of a sound investment anning policy will generate all nds of pressures for a decision witht adequate review and analysis. me of the arguments advanced are miliar to all of us:

- "Company X (our biggest rival) is doing it; we have to do it to be competitive."
- "It's our policy to be represented in new suburban areas."
- "We need the new facility to improve quality."
- "It will have great public relations value."
- "You just can't measure the benefits of this type of expenditure." (Or, "we've tried and don't like the result.")
- "We always replace our equipment at the end of eight years."
- "We just don't have time for your sharp-pencil analysis;; our major competition will take the deal next week."

In applying improved techniques of analysis, care must be taken to prevent the development of a bureaucratic system of investment control that leads to "death by deliberation." Management usually cannot afford the luxury of indefinite delay in the reinvestment of funds, because the sheer absence of a decision often represents a lost opportunity. The controller must have available the techniques for adequate review on a basis that permits *timely decision.*

Definition and Approval Of Objectives

As part of the program approval system, the objective of each major venture should be clearly defined and *approved* as part of the authorization for the expenditure of funds. Such program objectives should include:

1. The specific physical characteristics of the proposed product or facility program, including size, capacity, and performance.
2. Projected revenue-cost assumptions.
3. Total expenditures required to launch the program, including engineering, facilities, tooling, launching, and administrative costs.
4. A summary of the total projected profit position of the enterprise before and after the proposed investment.
5. Approved timing schedules for completion and introduction.

By having these objectives clearly defined at the time the program is

approved, the controller is in a position to issue periodic "status reports" summarizing progress against the approved objectives. As work proceeds, some adjustments in the original objectives may be required, but all amendments to these objectives should be cleared through and approved by the original authorizing agency on the basis of new data that will justify the modification.

Properly used, these "progress status reports" become one of the major control instruments for sound management planning by providing the foundation for a completely integrated financial planning control system. Each month, or at least each quarter, a complete three to five-year financial forecast of the firm should be revised to incorporate:

1. All changes that have taken place in the status of major programs as reflected in the individual progress reports.
2. Changes in the projected cost-revenue position of all major products of the firm that have become evident from recent economic or cost trends.
3. Revisions of sales objectives as required to reflect recent market trends.
4. Modifications in facility utilization plans.
5. An analysis of the effect of all of these changes on the net cash flow and projected profit position of the enterprise.

The periodic publication of a projected profit and loss statement for future periods serves the same purpose in management planning as the publication of financial statements and short-term forecasts used by operating management. In contrast with the regular operating and financial statements that are used by all levels of supervision, however, these forward financial projections can be designed to serve only the limited management group responsible fo forward planning, and these plannin reports can be more readily adjuste to the specific needs of managemen without regard to the traditions o conventions of regular operating re ports.

Just as the organized collection o actual costs and revenue provides th control mechanism for operating man agement, so the systematic collectio of financial data relating to forwar planning provides a disciplined re view of trends and progress that not available from random analysis o isolated progress reports.

A Restatement

In summary, a complete financia control system includes reports tha are specifically designed to serve bot the operating and planning respons bilities of management.

Reports Designed for Operating Management

- Financial Statements, including co and revenue detail
- Short-term Forecasts—4 to 6 months
- Annual Budgets or Profit Plans
- Annual Capital Budgets

Reports Designed for Management Planning

- Summaries of Major Program Obje tives
- Status Reports on Progress of Indivi ual Programs
- Periodic financial projections coverin the effect of all approved programs o the financial position of the firm ove the next three years
- Reports on the recovery and reinves ment rate of capital employed in th enterprise.

Many firms will undoubtedly ques tion whether the advantages of such completely integrated forward finan cial reporting system are not mor

an offset by its cost and complexity. rms that have established such a stem have not found the costs indinate and can attest to its value in anagement planning.

A more fundamental question might whether the accounting profession nsiders the development of such a rward financial reporting system the xt logical extension of its sphere responsibility in servicing business anagement. Or, more pointedly, any accountants might well ask hether the investment planning conpts discussed earlier have anything all to do with accounting. The acunting profession may have reached stage of development where it must cide whether it is willing to abdite its role of servicing management every area of the controllership nction. All too often in recent years, e accounting profession has been ilty of undue concentration on the chnicalities of account classification d valuation. In many firms the countant has literally stepped aside hile the legion of financial analysts, vestment analysts, facility analysts, d recently a new breed of "operations research analysts," pluck data indiscriminately from accounting reports for use as the building blocks of their own separate financial castles.

Who, more than the accountant—the man who collects the data and knows their limitations—is in a better position to use the data intelligently in guiding management decisions? The accounting profession might well reassert itself and begin to challenge the qualifications of this new group of planning analysts who all too often do not know the first thing about the foundation or composition of the cost and investment figures they use with the dogmatism of an algebraic equation.

The accounting profession can reaffirm its position in the planning phase of financial management only if it is ready to provide an integrated forward financial reporting system in this area of management responsibility equivalent to the system of reports already being used by operating management. To the extent this challenge is accepted, it could become the new frontier of accounting during the Sixties.

MANAGEMENT REPORTING

In essence, management reporting implies the preparation of internal ports on past performance, interpreted in a manner to stimulate decisionaking by management. Reports are the means of coordinating the activities an organization for review, discussion and policy determination. Such ports can range from daily analysis of materials, labour utilization and lesmen call reports, to annual reports on certain phases of business activity. ey include both financial and operating reports. The number of reports in e in business is frequently voluminous. They are, however, like the "house at Jack built," added to piecemeal and often not related one with the her. Neglect of the reporting structure can prove costly in times of recession rapid expansion in the country's economy.

The Canadian Chartered Accountant, December 1959
G. H. Cowperthwaite, "Management Reporting"

An illustration of the opportunities fo
civic service available to the CPA

Organization of a Fixed Assets Inventory For a Municipality: A Case Stud

By David Messro

When an Illinois City with a population of approximately 50,000, decided to establish better control over its fixed assets, it called upon its independent Certified Public Accountants. It was immediately apparent that a complete physical inventory of all property would be required. Great concern was expressed over the size of this project and the related cost. After much deliberation, the organization and supervision of the project was assigned to independent Certified Public Accountants. The physical count was to be performed by City employees.

The primary purpose of the inventory was to establish adequate control over fixed assets. Important information was gathered for insurance, budgeting, trade-ins and replacement. Facts were also assembled for use in financial statements and computing depreciation for utility or other enterprise funds. As cost data were not available in most instances, preser value was assigned to the assets b various department heads in conjun tion with the City Purchasing Agen It is well to point out that municip accounting principles provide for th presentation of fixed assets in th balance sheets of utility or enterpris funds or in a Statement of Gener Fixed Assets.

Score of the Assignment

The inventory was to encompass a City departments and semi-indepen ent activities. These included th following:

1. City Hall—land, building, and t offices of Mayor, City Manager, Ci Clerk, Engineer, Purchasing, Gener Administration, Planning, Police D partment, Personnel, Health Depar ment, Inspector and Police Magi trate.
2. Fire Department—land, fire statio and related equipment.

DAVID MESSRO is a member of the firm, Seymour P. Golden, Ro Island, and is a member of the Illinois Society's Local Governmen Accounting Committee.

3. Water Works — land, pumping station, filter plant, elevated tanks, storage domes, equipment and water mains.
4. Sewerage Works—land, lift stations, treatment plant, disposal plant, incinerator building, catch basins, equipment and piping.
5. Motor Vehicle Parking System — parking lots and parking meters.
6. Bridge—bridge, land, administration building, signs, shops and automotive equipment.
7. Library—land, buildings, equipment, books, films, periodicals, and phonograph records.
8. Equipment Maintenance—land, building, automotive and shop equipment.
9. Playgrounds and Parks — land, improvements, equipment and automotive vehicles.
10. Other Areas—traffic signals, street lights, fire alarm boxes, municipal barge terminal.

ooperation with Civic Personnel

The City Clerk scheduled a meetg of all department heads with the ertified Public Accountants. The eeting was to acquaint all departent heads with the proposed project id to inform them that the accountts would make a preliminary inspecon of all City property. The inspecon highlighted the fact that several ethods of taking the inventory would ive to be developed.

In order to start the inventory in comparatively simple manner, each partment head was asked to submit the City Clerk's office a list of land id buildings used by his department. t the same time, the City Attorney amined all documents pertaining to ity land and buildings. As this inrmation was forwarded to the City lerk's office, the engineering and anning departments were requested inspect each location and estimate e present value thereof. Circumstances under which improvements became a part of real estate had to be determined.

While the land and buildings were being inventoried, permanent metal identification plates and inventory tags (Exhibit A) were designed and procured. The metal plates contained a letter prefix to designate the appropriate department. The inventory tags were purchased in duplicate. The original was of sturdy bond paper, and the copy was of cardboard. The cardboard was specifically coated so that carbon paper would not be required.

For better control it is desirable to have a set of inventory tags in each department, as well as a master file to be maintained by the City Clerk. The duplicate inventory tags were designed so that the original and duplicate would serve as the department file and the master file respectively without the necessity of recopying.

The following additional items were considered in preparing the inventory tags:

1. Pre-numbering for control in taking the inventory.
2. Assigning of permanent identification numbers to each item.
3. Space for complete information concerning the item.
4. Information relative to the ultimate disposition of the asset.

Control Procedures

Written instructions were prepared explaining the method of taking the inventory. Each department head was asked to designate employees under his supervision to take the inventory. The department heads and assigned employees met with the accountants to review the instructions and to resolve any general or departmental problems. The employees were instructed to fill

TAG

No. 3151

ASSIGNED NUMBER D-36

Item ½ H.P. Motor	Model 3 Cyl.
Model Year 1957	Mfg. Name National
Ser. No. 5926932	Eng. No. 637846
Date Acquired 1957	New or Used New

Supplier Motor Sales Inc.

Location Water Department

Department Equipment Maintenance

Manner of Disposition Traded

Date of Disposition Mar. 11, 1959	Amount Realized $50.00

Traded for 2 H.P. Motor

Condition in 1958 * Fair

Estimated Value in 1958 or Cost ** $60.00

No. 3151

Exhibit A—Inventory Tag

* This line is to be used for the initial inventory only.

** This line is to contain the estimated value at the time of the initial inventory. For subseque[nt] acquisitions, the cost is to be entered.

in all of the applicable blanks in the upper portion of the tag. The original copy of the inventory tag was to be detached, and the duplicate copy was to be securely affixed to the item. In the event that an inventory tag was voided, the employees were instructed to retain the original and duplicate copies. After the inventory, the employees returned to the department head all unused and voided inventory tags and the originals for all fixed assets in their department. Each department head was responsible for a[ll] tags issued to him.

After tests by the Certified Publ[ic] Accountants, the department hea[d] and purchasing agent picked up all [of] the duplicate inventory tags attache[d] to the items. At the same time, the[y] assigned present value to the asse[ts] and determined the condition there[of]. The permanent metal plate was s[e]cured to the item and the assigne[d] number entered on the original an[d] duplicate inventory tag. As the d

artment head and purchasing agent ollected the tags, they were requested be on the alert for items which ad been overlooked by the employee r erroneously tagged. After all of he tags had been collected, the pre-umbered sequence was accounted for. 'he department head retained the riginal inventory tag in his files, nd the purchasing agent submitted he duplicate copies of the tags to the 'ity Clerk for the master inventory le.

Inventorying procedures in the va-ious departments were scheduled so hat the purchasing agent would not e absent from his office for more than wo consecutive days. This enabled im to visit each department without reatly curtailing his normal pur-hasing duties.

pecial Problems

Automotive equipment presented a pecial problem. Where a vehicle had ttachments such as heavy duty gen-rators, sirens, drag shovels, revolving ed lights or radios, and these attach-nents would ordinarily be removed t the time the vehicle was traded or old, these items were separately nventoried.

Most of the fixed assets could be nventoried and controlled through nventory tags, but there were some vhich did not lend themselves to this rocedure. The following paragraphs et forth methods used for special ategories.

A conference of the Superintend-nts of Water and Sewerage, City Engineer, City Planner and account-nts was held to determine the most ractical way to inventory water and ewer pipes. It was agreed that the nost complete information could be btained by reference to the maps of the City. The superintendents and the city engineer were requested to study and evaluate the maps and to issue a report containing the number of miles of piping by size, fire hydrants, manholes and other major items and to estimate their present value. Although this was a time-consuming task, it was the most practical approach which could be taken to the problem. This same procedure was used by the inspection department in gathering information pertaining to street lights, traffic signals and the city fire alarm system.

The water department submitted a list of all spare water meters on hand. An analysis of the water billing records maintained by the City Clerk's office was used to determine the number and sizes of water meters on the premises of the consumers. Identification of specific water meters was not deemed material, as long as they could be accounted for in total.

From available records, the librarian furnished a letter estimating the value of books, phonograph records, films and periodicals maintained at the main library and the various branch locations. The police and fire departments submitted lists of all special protection equipment used in their departments, such as firearms and gas masks. The manufacturer's serial number was assigned as the permanent identification number since the attachment of a permanent plate was not practical. Parking meters on location and replacement meters were counted and are controlled in total only.

The Bridge Commission had original cost records for most of its fixed assets including land, bridge and buildings. As this information was available, and as the present value of

bridge assets was difficult to ascertain, it was decided to record bridge assets at cost.

Streets, sidewalks and alleys were not included in the initial inventory. This part of the project was deferred temporarily.

Recording of Changes

A great deal of time and effort was expended in taking the inventory and establishing control over the City's fixed assets. In order to obtain full benefits and to maintain adequate control on a continuing basis, it is essential that the inventory records be kept current at all times. To accomplish this, the following procedures for reporting changes were established:

A. Each department head is to secure blank duplicate inventory tags to be retained in his office.

B. When a fixed asset is acquired, without a trade-in, a new inventory tag is to be prepared.

1. All blank spaces in the upper portion of the inventory tag are to be completed. The cost is to be entered on the last line of the tag.
2. The original copy of the inventory tag is to be retained by the department in its inventory file.
3. The duplicate copy of the inventory tag is to be sent to the City Clerk to be retained in the master file.
4. The City Clerk's office will issue a metal plate to the respective department whenever appropriate.
5. As the metal plates are assigned, the numbers are to be entered on both the original and duplicate inventory tags.

C. When a fixed asset is acquired and a trade-in is involved, processing is as follows:

1. The inventory tag is prepared and the metal plate attached as set forth in B, above.
2. The inventory tag for the item traded in is to be removed from the department inventory file. The spaces in the lower portion are to be completed, and the tag is placed in a dead file.
3. A disposition report (Exhibit B) is to be sent to the City Clerk's office where the inventory tag in the master file will be removed, attached to the report and placed in a master dead file.

CITY OF __________, ILLINOIS

FIXED ASSET DISPOSITION REPORT

City Clerk
Department

March 10, 1959
Date of Disposition

4 Dr. Desk
Item Disposed Of

A-231
Assigned Number

Traded
Manner of Disposition

$50.00
Amount Realized

Traded for 6 Dr. Metal Desk

To Whom Sold or Traded Lincoln Furn.

Department Transferred to __________

Signature *John Jones*

Exhibit B—Disposition Report

D. Each time an item is sold or scrapped, the procedures are to be the same as set forth in C, 2 and 3.

E. On the acquisition or disposal of fixed assets, which because of their nature have no inventory tags, a detailed memorandum is to be prepared by the department.

F. When fixed assets are transferred from one department to another, the trans-

ferring department is to note this fact on its inventory tag and submit a disposition report to the City Clerk's office. If the transfer is of a temporary nature, then the inventory tag is to be retained in the active inventory file of the transferring department. If the transfer is of a permanent nature, the transferring department is to send its inventory tag to the department receiving the item. The receiving department will retain the tag in its active inventory file. The City Clerk's office will also amend its copy of the inventory tag in the master file to reflect current location.

. The purchasing department is to notify the City Clerk's office whenever it places an order for the purchase of a fixed asset, so that the Clerk can expect notification from the appropriate department.

. The City Clerk's office will make appropriate accounting entries to reflect acquisitions, dispositions and transfers.

An Appraisal

The completion of the procedures described established a comprehensive record of fixed assets at a minimum cost to the City. A test count of assets is to be made at convenient intervals during each year. The results will be compared with the department and master inventory file.

Each department head is accountable for the assets assigned to his department. When there is a change in department heads a physical inventory is to be taken in order to transfer accountability.

The Banker, The CPA, & The Revolving Door

(continued from page 14)

cedures, we may be at a disadvantage in properly marshaling our arguments pro and con. On the other hand, an accountant cannot expect to be free of criticism if he fails to make clear his responsibility for the figures presented by the issuance of an unqualified opinion, a qualified opinion or a disclaimer of an opinion.''

Perhaps the way to get out of the revolving door is to stop swinging, stop complaining, and concentrate on mutual understanding.

A statement outlining the real nature and limits of cash basis statements and the related responsibilities of the CPA.

Cash Basis Statements

By George Richards

The phrase, "Cash Basis Statements," is used to describe the financial statements of those organizations which maintain their accounts materially at variance from the concepts of accrual accounting. These organizations may include some organized for profit, particularly those carried on by individuals and partnerships, as well as some nonprofit organizations. Frequently, captions customarily appearing in financial statements prepared on the accrual accounting basis will be used. Thus, cash basis statements may include so-called "balance sheets," "income statements" and the like.

Generally Accepted Standards

In Statement On Auditing Procedure No. 28 the Committee on Auditing Procedure of the American Institute of Certified Public Accountants gives general recognition to this subject. The Statement acknowledges that the certified public accountant has little besides his own experience and judgment when reporting on financial statements other than those of corporations organized for profit. I am sure that our own experience in researching accounting and auditing problems confirms this fact. While established precedents guide our application of generally accepted auditing standards in the usual corporate situations, there is little to assist us when we are confronted with audit engagements outside this area.

Specially, we have the problem of conforming our reporting practices on cash basis statements to meet the requirements of generally accepted auditing standards. To refresh your memory, these are:

1. We must state in our report whether the financial statements are presented in accordance with generally accepted accounting principles.
2. We must indicate whether these principles have been applied consistently in the current as well as the preceding period.
3. We must assume responsibility for informative disclosures in the financial statements.
4. We must either express a qualified or unqualified opinion on the financial statements, taken as a whole, or disclaim any opinion and state our reasons therefor.

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Applicability To All Situations

These standards of reporting sug-est the basic philosophy and objec-ves of our auditing assignments. heir observance is necessary to clear-r define the responsibilities that we re assuming on auditing engage-ients. It is quite evident however iat these reporting standards were esigned primarily for application to prporate financial statements pre-ared under accrual accounting meth-ds. While it cannot be said that pplicability is restricted to such nancial statements, nonetheless many f our reporting problems are created hen we attempt to apply these rules) other accounting presentations.

Fortunately, today we have the uidance of Statement No. 28. A close udy of its provisions will clarify iany of the reporting problems here-ofore associated with cash basis state-ients. Statement No. 28 has a two-bld purpose. First, it provides us ith a basis for distinguishing finan-al statements susceptible to the ording of the customary account-nts' report from those that may re-uire special wording. In the State-ient the latter are described as "Spe-al Reports." The second purpose f Statement No. 28 is to clarify the pplicability of generally accepted uditing standards to Special Reports. hus, it is now possible to point to omething more specific in bringing ie cash basis statement within the ramework of our general philosophy nd objectives in auditing engage-ients.

pecial Reports

Statement No. 28 furnishes some eneral definitions of Special Reports. mong these, financial statements repared from cash or other incomplete bases of accounting are included. Financial statements of this type are frequently prepared for small business organizations such as partnerships and sole proprietorships, but also might include nonprofit organizations applying accounting practices peculiar to their own activities. For example, financial statements of municipalities, hospitals, cooperatives, educational institutions and the like.

The Committee on Auditing Procedure of the Institute makes one important exclusion. This might apply to cash basis statements that otherwise would be considered under the general classification of Special Reports. It relates to financial statements of organizations coming within the classification of regulated industries. While the Committee recognizes such statements can contribute their share of reporting problems, it did not consider it appropriate to include these under the definition of Special Reports as used in Statement No. 28. In particular, the Committee had in mind financial statements of banks and other financial institutions, insurance companies, railroads and other industries where accounting practices either in part or in whole are prescribed by regulatory authorities.

Thus, when we discuss cash basis statements, we are talking about financial statements of organizations whose accounting practices are not regulated and yet at the same time are incomplete as measured by accrual basis standards.

Reporting Problems

At first glance it may seem illogical that accounting on such a simple basis as cash receipts and disbursements can produce financial statements that

contribute reporting problems. However, the reason for this is quite evident. Financial statements prepared on the cash basis, except by mere coincidence, do not portray financial position or operating results. Occasionally, financial position and operating results, as determined by accrual methods, might not be materially different from financial data under cash basis accounting. However, this happens rather infrequently. The net result is that when the certified public accountant drafts a report on cash basis statements, he is rarely in a position to give an opinion that such statements reflect financial position and operating results.

This does not mean that cash basis statements do not serve a useful purpose. In many cases they are not only adequate for the needs of the particular organization, but accrual basis financial statements might be less useful. In some organizations, particularly those in the nonprofit category, cash flow and accountability have more significance than accrued financial position or earnings. While it is true that cash basis statements do provide significant financial data, the CPA must approach them with caution and with the exercise of extra care to be sure that misleading inferences are not drawn from them.

The Form of The Auditor's Report

In this connection a quotation from Statement No. 28 is appropriate:

> "Statements prepared on the basis of cash receipts and disbursements, for example, usually do not purport to present financial position or results of operations. In reporting on statements which do not so purport, the auditor should make sure that it is clearly stated what they purport to present and the basis on which they have been prepared."

It is evident from the foregoing tha the usual form of the accountant's opinion in most cases will be inappro priate in reporting on cash basis statements. Moreover, there are good reasons to avoid the use of statemen titles that might convey an erroneou impression on what the statement purport to show. The terms "balanc sheet" and "income statement" ma be misleading descriptions of th financial data presented. In lieu o presenting a "balance sheet" th statement could be titled "Statemen of Assets and Liabilities Resultin from Cash Transactions," and i place of an "income statement" th caption, "Statement of Cash Receipt and Disbursements on Account o Income and Expenses," might be used In all cases, in establishing titles t identify cash basis statements, th burden of responsibility rests wit the certified public accountant r porting on such statements to be sur that no misleading inferences will b drawn. It seems logical that the star ing point should be in the statemen titles, although in a given situatio it might be desirable to disclose the facts in statement footnotes and/ in the accountant's report.

The Score of Responsibility

Another important point made i Statement No. 28 is that in reportin on cash basis statements it is n sufficient to take a negative approa by merely stating that they do n purport to show financial position results of operations. The certifi public accountant has the addition responsibility of stating what they purport to present and the basis which they have been prepared. H then should express his opinion as whether the statements in fact prese

ıe financial data on the basis indi- ıted. This seems reasonable and con- ›rms with our responsibility in re- orting on financial data. To fulfill nd yet place some reasonable limits n our responsibility we must refer pecifically to a financial statement, ·hedule, exhibit or other presenta- on prepared by the client who is ıking primary responsibility for its ccuracy, and having examined it, ıcluding underlying records, we ex- ress an informed opinion on whether presents what it purports to show. o my thinking, this approach is very nportant. I do not think that we ıould take a greater degree of re- ponsibility by stating that we have xamined accounts and records relat- ıg to cash transactions or otherwise ıfer that we have made a detailed nd exhaustive audit of these items. xcept in unusual circumstances, this never the case. Our responsibility s auditors is an over-all responsibil- y relating to fair presentation—a omewhat different approach from omplete vertification of the accuracy ı the recording of accounting data.

Many of us are aware of the im- ortance of an over-all objective in very audit. A reconcilement of a ınk account, a count of a petty cash ınd, confirmation of accounts receivable, etc., are not in themselves audit objectives. They are a means to an end—the accountant's opinion. Unfortunately, there are still some in the business community who are unaware of what we do, and even among our own profession, I sometimes feel we don't give proper recognition to our over-all audit objective. Statement No. 28 is an important contribution to accounting philosophy and will in the future make it easier for us to apply this thinking to unusual accounting situations such as the cash basis financial statement.

In Conclusion

To summarize, we must recognize the cash basis statement for what it is. We should make it clear to the reader of our report what it purports to show. Moreover, we must define our own responsibility with regard to this presentation with a clearcut statement of our opinion as to whether there has been a fair presentation of the financial data. In the last analysis, we must always bear in mind the importance of conveying information to the reader of our report that will be informative within the limits of our responsibility and at the same time avoid any misleading inferences.

Men in great places are thrice servants; servants of the sovereign or ate; servants of fame; and servants of business.

—*Bacon*

TAX COMMENTS: Prepared by the Committee on Taxation of the Illinois Society of Certified Public Accountants

Entertainment Expenses

A "Yankee Doodle" taxpayer, born on the Fourth of July, may not be entirely deprived of his entertainment expense deductions even though some of these expenses may have been "riding on the ponies" and though he kept no exact account of such expenses. In the famous Cohan case, the Second Circuit directed the Tax Court to make an approximation of expenses, "bearing heavily, if it chooses, upon the taxpayer whose inexactitude is of his making." This article will deal primarily with a taxpayer who is inexact, but not of his own choosing.

Interpretation by The Courts

To be deductible from income, entertainment expenses must be

(1) Ordinary and necessary, and
(2) Paid or incurred during the taxable year as one of the following:
  (a) an expense in carrying on any trade, business or profession (Sec. 162), or
  (b) a "non-trade" or "non-business" expense; that is, an expense in connection with (1) the production or collection of income; (2) the management, conservation, or maintenance of property held for production of income; or (3) the determination, collection or refund of any tax (Sec. 212).

If an expense is common in the trade, occupation, profession or community of a particular taxpayer, it would undoubtedly qualify as an ordinary expense. But the Supreme Court has held that ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often, but that the expense is an ordinary one in that we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted occurrences in the field of business. A non-trade or non-business entertainment expense described in the preceding paragraph under 2(b) may not in most instances qualify as ordinary, because it may not be considered as a common and accepted occurrence in such non-trade or non-business connections. However, any entertainment expense incurred with a business purpose or for the production of income would appear to qualify as ordinary in practically every case, since they certainly are common and accepted occurrences in today's field of business. To qualify as necessary in this context, it is not required that such expenses be essential. They are considered necessary if they are appropriate and helpful to the taxpayer's field of business or occupation. The taxpayer's principal burden, therefore, is to prove that the expenditure was actually made for a business purpose.

JAMES O. WHITMORE, who is a partner of the firm, Otto Hillsm & Co., Chicago, prepared the comments for this issue.

atisfactory Records

It goes without saying that a par-
cular taxpayer's return may never
e questioned by the Treasury Depart-
ent; in fact, those that are ques-
oned are still in the minority. If all
e facts are properly detailed on the
turn, it is possible that the return
ill be passed without questioning
e taxpayer. On the other hand, if
quired details are omitted, if income
quite large, or if the amount of
y deductions seem out of proportion
the income, the taxpayer usually
ill be asked to furnished records to
bstantiate deductions and/or ex-
enses. In such a case, the examining
gent will almost certainly require
cords and other evidence of expendi-
res for entertainment. Whenever
ssible such records should be com-
ete and detailed, including such
ings as telephone calls and telegrams
ith dates, names of customers, cities
d towns visited, amounts spent,
ubs of travel tickets, cancelled checks
receipts whenever obtainable, and
least a small memo book with these
d other pertinent details. Such
cords will usually prove that the
aimed expenditure was actually
ade, but they do not always prove
at the expenditure arose primarily
cause of the taxpayer's business or
come producing activities. Where
ch proof is lacking, it may be deter-
ined to be a non-deductible personal
penditure. On the other hand, if
can be shown that the expenditure
as made to drum up business or
come, it should be allowed. It should
t be necessary to show that the ex-
nditure resulted in actual business
it was incurred primarily for that
rpose, but if actual business does
sult, there would be little question
out the propriety of the deduction.

Incidentally, in the case of a salaried employee deducting entertainment expenses under "itemized deductions," the writer has assumed that the employee has a proper understanding with his employer regarding the employee's obligation to pay for certain expenses, being reimbursed through his salary.

Who Maintains The Records?

The foregoing would definitely imply that a person in a responsible sales capacity, such as a sales manager, who must of necessity do a great deal of spending for entertainment to drum up business and keep it drummed up must also of necessity do a lot of record keeping. That's fine if he can find the time to do it, but he may be in a very competitive "dog eat dog" type of business that demands all of his energies just to maintain his competitive position. Everyone knows what his employer would say if he spent a lot of time keeping detailed records of his expenditures while the sales volume fell. He would be advised to spend all his time devising ways and means to increase sales and to forget everything else—or else. This type of individual usually is obliged to be free handed in entertaining customers and prospects, their employees and others who may be of help to him in furnishing him with sales promotional material or ideas. As a result it may become all but impossible for him to keep any records at all.

In order to illustrate a point, let us assume that the sales manager's salary is $60,000 per year. His company, knowing that he must entertain, allows him $15,000 in addition to his salary. He probably spends $25,000, and he keeps no records. It is mani-

festly appropriate to recommend that he employ a CPA to set up beginning and ending balance sheets. His bank accounts will show beginning and ending balances, and receipts and disbursements out of the bank account may be reviewed to determine any capital items bought or sold. Undoubtedly, there will be large unexplained cash withdrawals. Here the CPA will, with advice from the taxpayer, make a determination of what the normal living and personal expenses of the taxpayer and his family are and assume the balance to be spent for entertainment. This is the so-called Net Worth method which the Treasury Department uses against the taxpayer, so the taxpayer should be allowed to use it in appropriate cases. In other words, if the inexactitude is not the fault of the taxpayer, and therefore not of his making, the reason for "bearing heavily upon the taxpayer" no longer exists. There are many instances where the services of a qualified CPA in making such an approximation could prove to be extremely valuable to the taxpayers, furthermore, the cost of the CPA's service would be deductible. It does not seem proper that a taxpayer be deprived of tax benefits simply because he is too busy earning income to keep detailed records.

Application To The Practitioner

The Commissioner has taken steps recently to correct the tax abuses on entertainment expenses which he feels to exist. The tax information services and the newspapers have given full texts of the new Internal Revenue Service reporting requirements for businesses so repetition here is not necessary. However, it is strongly recommended that all practitioners be completely familiar with the new requirements which are effective for tax years beginning after December 31, 1959.

PROFESSIONAL INFLUENCE

The growth of corporate business stimulated the development of two professional groups which are closely concerned with the reports of companies. These groups are accountants and stock and share brokers. Their functions were carried out long before limited liability companies became numerous but the provisions of means by which the public could invest in business enterprises has greatly increased the importance and impact of their services. Both groups have had and continue to have a direct, and not easily, a capable, influence on the publicity given to the affairs of business corporations.

R. J. Chambers, *The Function and Design of Company Annual Reports*

ontinued from page ix, President's Page

necessarily be embraced in the connotation of the name by which our profession is known.

In the March 1960 issue of the American Institute's membership bulletin, CPA, a question is raised as to why shouldn't CPAs expand their practices in the area of personal financial management for the average citizen. It was observed that even the employee on a modest salary has financial problems which to him are vital (e.g., "How much rent should he pay—or should he buy a home? How much of what kind of insurance can he afford?"), and the opinion is expressed that such individuals would often welcome consultation with experts if they knew where to go. Even if it could be safely assumed that public accountants are competent to give advice on these matters, state legislators might begin to question the need for CPA laws, should public accounting practice become to any major extent the rendering of this type of service.

Competence, integrity and independence are the footings upon which our profession rests. That these are the characteristics needed in a limitless variety of endeavors is the obvious explanation for the temptation to broaden the scope of services we render. The principal activity of our profession in which there is a public interest, however, is expressing opinions on financial statements as independent accountants.

New problems continue to arise in planning efficient audits, and there are many questions involved in financial statement presentation for which perfect answers have not yet been found. We might better direct our attention to professional development in the area which is the foundation for the CPA than to the sidelines.

As individuals we do everything possible to avoid acquiring an unjustified personal reputation. It is equally important that we avoid creation of an inaccurate reputation for our profession. The general public is constantly asking CPAs as a group, "What is Your Name?"

AS WE GO TO PRESS

OUR NEW LOOK

After many months of meetings, letters, and calls, we are happy to introduce this new format of the Society's journal to our readers. We wish to acknowledge the helpful counsel given by so many of the Society's officers and members of the Society and the excellent guidance given us by Mr. Herbert Auer, publications specialist, from Lansing, Michigan. We invite your full and critical examination of all the elements that comprise the new format: the cover design, new official name, President's page, Letters to the Editor, type style, and design theme. It is our hope that the new look is also a forward look. Tell us your reactions and recommendations.

LETTERS TO THE EDITOR

The Editor of TIME (June 13, 1960) reported that 20,153 letters had been received from its readers during the first five months of 1960. We do not anticipate or honestly invite such a response from the readers of THE ILLINOIS CPA, but we would welcome your comments on previously published articles in particular and any other observations of pertinence to our profession in general. We are certain that you will find Mr. George O. May's comments (p.v.) on an earlier article written by Professor A. C. Littleton informative because of its own content and also illustrative of the benefits made possible when you share your opinions with others.

IN THE NEXT ISSUE

The Fall issue promises to be especially attractive because of the planned inclusion of articles by each of the following particularly qualified individuals:

Louis M. Matusiak (Director of Continuing Education, American Institute of CPAs)

Lloyd Morey (President Emeritus, University of Illinois)

Donald L. Calvin (Securitis Commissioner, State of Illinois)